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Via email

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Dear Mr. Guzy:

Re: Further supplementary proposed rule
30 CFR Part 206, 63 FR 40073

As a participant in the discussions that have taken place during the month of July between representatives of the MMS and senior industry executives, we are extremely disappointed in the agency's July 24 response to a series of constructive, compromise proposals submitted by the industry.

In key areas such as tendering, transportation, and "duty to market" the agency has demonstrated a remarkable intransigence and a total unwillingness to consider industry's compromise suggestions and the realities of the marketplace.

Despite overwhelming evidence to the contrary, the MMS steadfastly maintains that there is no market for oil at the lease. In one respect, that intransigence is understandable, because if the agency were to acknowledge a viable market at the lease (as evidenced by the testimony of reputable economists and the experience of major producers that actively

sell production at the lease through a competitive bidding process), it would then become necessary to back away from the agency's inflexible fixation with moving away from the lease to seek complex netbacks from arm's length dispositions far removed the point of production on the lease.

The MMS' July 24 response to non-arms length compromises suggested by the industry reflects a misunderstanding that has lead to a false conclusion. The industry's menu of options was submitted with the full expectation that a lessee would be obligated to notify MMS of its menu selection; that the selection would be binding on a specified geographic area, such as the Gulf of Mexico; that it would be in effect for a designated time period, such as two years; and that one or more backup selections would be required in a specified order. For example, if tendering were the option of choice, an index with adequate reasonable deductions would be the next alternative if tendering at certain lease locations were not successful.

The categorical MMS rejection of tendering (and the attendant suspicion that producers will somehow game the system by selling production at less than market value) is factually flawed. Several major companies have established active and effective tendering programs. The bids received in Shell's program, for example, are for production at the lease. The purchaser must arrange and pay for transportation and reflect appropriate quality and other costs in its bid. Bids are solicited from a range of companies, large and small, including trading companies, re-sellers, marketers, and refiners. Any qualified bidder is welcome to bid so long as they meet Shell's credit requirements.

Shell's tendering program achieves prices based on competitive commercial terms which include adjustment back to the lease. The use of a tendering program achieves the same goals MMS has sought with the use of a market index without requiring preparation of and review by MMS auditors of transportation, quality and location differentials through several layers of movement. All participants in the oil markets recognize that index prices internalize the costs of transportation, adequate and ready storage, fixed and constant supply with no lease shut-in risk, and fixed quality in large volumes ensuring delivery under an index contract. With tendering, the purchasers, acting rationally to optimize their own positions, determine the relative values of crude at various lease locations factoring in the costs of transportation, differences in quality and location. In addition, not only is the complex and costly process of tracing back to the lease through netback eliminated, the whole controversy over marketing allowance is also eliminated since sales occur at the lease. MMS' objective of achieving market transparency is achieved with a competitive bidding program at the lease.

MMS' comments of July 24 on transportation tariffs are totally at odds with the intent of the Congress. In the Energy Policy and Conservation Act of 1992 (EPACT), P.L. 102-486, the Congress specifically found all then existing oil pipeline tariffs to be just and reasonable. The Congress also reaffirmed the jurisdiction of the Federal Energy Regulatory Commission (FERC) over the establishment of oil pipeline rates. Further, the U.S. Supreme Court and various Federal Appeals Courts, over sixty or more years of review, have determined that a light handed approach to oil tariff regulation is all that is needed since the marketplace adequately regulates itself.

The procedures for establishing pipeline tariffs at the FERC require public notice and allow participation by any affected party. MMS is now attempting to declare unilaterally what the policy of the federal government should be on oil pipeline rates. Unlike the

FERC, MMS does not have the statutory authority nor does it have any expertise in pipeline ratemaking as evidenced by its misapplication and basic lack understanding of the utility-type cost of service model it seems to be determined to use in setting transportation allowances.

The agency continues to insist that companies only be allowed to deduct transportation costs as calculated under a contrived cost of service formulation unique to MMS. The FERC and other such regulatory agencies responsible for establishing cost of service rates for regulated entities recognize the cost of capital of the entity making the investment. The offshore industry finances facilities primarily with internally generated funds. As such, a typical equity to debt ratio for an offshore company might be close to 85% to 15%. MMS' arbitrary use of Moody's triple BBB bond rate as the allowed return on shareholder's at-risk equity would be considered unacceptable by any legitimate regulatory body or court. Shareholder equity is subordinate to every other obligation of the company, including bondholders. So, even if a cost of service type approach were to be allowed, at a minimum, it would have to provide for a fair return on the equity portion of the capital structure commensurate with the associated risks. MMS itself has used up to 15% as the assumed necessary return in evaluating royalty relief applications. Incorporating this universally accepted principle would generate a 13.8% return on capital under an 85:15 capital structure assuming 15% return on equity and 7% (from Moody's) on debt.

The allowed return is only one flaw in MMS' determination to alter current law on oil pipeline rates. Oil pipelines are not public utilities with guaranteed cost recovery. The

model MMS seems intent on forcing on the industry is inappropriate for the market and federal regulatory structure of the oil pipeline business. An artificially constructed cost of service model with no guarantee of cost recovery is frankly confiscatory and counter to Congressional intent affirmed only a few years ago.

Instead of accepting the validity of FERC tariffs for transportation allowances for royalty calculations, MMS has suggested that industry submit comments on an MMS implementation of some type of area rate clause determination or mini-FERC rate setting process in order to determine transportation allowances.

The focus on tariff rates is somewhat contrived, the real issue is the value the market attributes to transportation service. MMS' factual assertion that very small volumes of oil are moved at arm's-length is wrong. Shell's Central Gulf System transports close to fifty percent (50%) third party non-lessee oil. This Central Gulf System is a major link in offshore oil movement. Arm's length transportation contracts are frequent and are readily available to MMS from all royalty payors. MMS has placed great reliance on the arm's length contract for oil value determination but has refused to use or even consider comparison to arm's length transportation contracts for determining value of transportation. Use of these arm's length comparisons would not only eliminate any necessity to resolve or consider the validity of FERC tariffs, but also eliminate the necessity to set up a mini-FERC within MMS. This approach to cost of comparable service is not new. The cost of comparable service was routinely accepted by MMS pre-1988 to determine transportation allowances.

Federal statutes at 31 USC §9701 provide specific guidance to the United States on how to determine the value of services provided to the United States. Among the criteria used by the United States are a determination of whether a service is provided, fairness, the value of the service to the recipient, and the value paid by others in the marketplace for

the service. Transportation is a service. Industry only asks that the same criteria be applied to determine industry's transportation allowance.

Considering MMS' continued desire to cling to a position unsupported in traditional oil and gas practice and in judicial interpretations of lease obligations, we are prepared to acknowledge that the "duty to market" issues will apparently be decided in the courts and need not stand as an obstacle in this rulemaking. We are confident our position will prevail in the courts because:

- There is no specific language in the federal lease or mineral statute that imposes such an obligation on the producer beyond cleaning up the production at lessee expense to put it in marketable condition.

- Marketable condition has been defined to be a condition which a buyer would customarily accept for sale in the field or area.

- Costs incurred to secure a sale of the marketable clean hydrocarbon at distances away from the lease are to be shared by lessor and lessee.

- The MMS has explicitly recognized this fact by charging an "administrative fee" when it takes oil in kind, but steadfastly resists any suggestion that industry should receive an equal fee in return for value added way from the lease.

The principal reason for sharing costs is that courts and reasonable parties have always understood that the hydrocarbon value is increased by economic factors present away from the lease. Since a lessor enjoys this added economic benefit, lessor has always shared in costs incurred to reach a market away from the lease. To do otherwise would

be to give all economic benefit to lessor with no corresponding risk or economic costs. Such unreasonable and inequitable a covenant cannot be implied but must be expressly stated either in contract or in law. Furthermore, it is contrary to the basic distribution of risks under the mineral lease where the lessor takes cash value for royalty in exchange for not assuming risks which accompany achieving increased value away from the lease.

MMS rejected industry's compromise that it be allowed to charge the same administrative fee the MMS charges when it takes oil in kind. The term "administrative fee" was used purposefully in order to avoid conflict and look for compromise with the agency. Instead, in its July 24 response, the MMS re-characterized it as a marketing fee, denied industry any opportunity to collect it but stated that for royalty in kind (RIK) purposes it was not a market fee but a simple administrative fee which the agency in RIK dispositions could collect.

In summary, the MMS has not addressed in any substantive or significant way, the flawed starting point for valuation downstream. This downstream, netback orientation imposes an obligation to collect voluminous data and to maneuver through unduly complex and vague requirements. The downstream tracking is unduly burdensome and relies on a false factual assumption of the lack of a market at the lease. In some cases, it is impossible to accomplish given practical realities of commingling and multiple exchanges in crude markets away from the lease. The Office of Management and Budget has understood these concerns and has twice rejected the MMS proposed Form 4415. Yet, MMS has continued to ignore industry comments on this matter.

MMS is not only unwilling to clarify or simplify its valuation requirements, but is also unwilling to establish a process by which companies can obtain binding valuation determination. Of course, the Secretary "may" make determination. What was indirectly

requested was that the Secretary "will" or "shall" on request make a binding determination. Even the highly criticized Internal Revenue Service is willing to offer and be bound by Revenue Rulings to taxpayers. This MMS reluctance is indicative of a mind set that wants to maintain all options for looking back to re-value hydrocarbons based on the perfect vision of hindsight.

In summary, MMS' July 24 response has not only failed to cure the flaws present in the February 1998 notice of rulemaking, but has also indicated an unwillingness to seriously consider well reasoned criticism of its proposal. This approach will lead to further controversy, uncertainty and confusion costing the royalty payor and states significant sums to audit, validate and defend against. We urge MMS to reassess the direction and fundamental premises on which the rulemaking is based.

Sincerely yours,

Stephen E. Ward
Vice President, Government Relations